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Committee of Experts on International Cooperation in Tax Matters
Sixth session
Geneva, 18-22 October 2010

Provisional agenda

1. Opening of the meeting by the Chair of the Committee.
2. Adoption of the agenda (E/C.18/2010/1) and organization of work (E/C.18/2010/2).
3. Discussion of substantive issues related to international cooperation in tax matters:
   (a) United Nations Model Tax Convention update (E/C.18/2010/CRP.1);
   (b) Dispute resolution (E/C.18/2010/CRP.2);
   (c) Issues related to attribution of profits under article 7 of the United Nations Model Convention (E/C.18/2010/CRP.3);
   (d) Transfer pricing: practical manual for developing countries (E/C.18/2010/CRP.4);
   (e) Article 13: capital gains (E/C.18/2010/3);
   (f) Taxation of development projects (E/C.18/2010/CRP.5);
   (g) Exchange of information (E/C.18/2010/CRP.6);
   (h) Tax treatment of services (E/C.18/2010/CRP.7);
   (i) Article 14 of the United Nations Model Convention (E/C.18/2010/4 and E/C.18/2010/CRP.8);
   (j) Definition of permanent establishment: proposed revised article 5 commentary (E/C.18/2010/5 and E/C.18/2010/6);
   (k) Concept of beneficial ownership (E/C.18/2010/CRP.9);
   (l) Revision of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (E/C.18/2010/CRP.10);
   (m) Capacity-building (E/C.18/2010/CRP.11);

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(n) Tax cooperation and its relevance to major environmental issues, particularly climate change (E/C.18/2010/CRP.12);

(o) Tax competition in corporate tax: use of tax incentives in attracting foreign direct investment (E/C.18/2010/CRP.13).

4. Dates and agenda for the seventh session of the Committee.

5. Adoption of the report of the Committee on its sixth session.

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Committee of Experts on International Cooperation in Tax Matters
Sixth session
Geneva, 18-22 October 2010

Organization of work

Date	*Item*	
Monday, 18 October 2010		
9-10 a.m.		Registration of participants
10-10.30 a.m.	1.	Opening of the meeting by the Chair of the Committee, Mr. Armando Lara Yaffar.
	2.	Adoption of the agenda (E/C.18/2010/1) and organization of work (E/C.18/2010/2) including consideration of rules of procedure and other organizational issues (if necessary).
	3.	Discussion of substantive issues related to international cooperation in tax matters:
10.30-1 p.m.		3 (a) United Nations Model Tax Convention update (E/C.18/2010/CRP.1);
		Presenter: Mr. Oliver
3-6 p.m.		3 (b) Dispute resolution (E/C.18/2010/CRP.2);
		Presenter: Ms. Devillet
Tuesday, 19 October 2010		
10-10.30 a.m.		Report of the Rapporteur on items 3 (a) and (b)
10.30-11.15 a.m.		3 (c) Issues related to attribution of profits under article 7 of the United Nations Model Convention (E/C.18/2010/CRP.3)
		Presenter: Mr. Oliver
11.15-1 p.m.		3 (d) Transfer pricing: practical manual for developing countries (E/C.18/2010/CRP.4)
		Presenter: Mr. Sollund

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Date	*Item*
3-5 p.m.	3 (d) Transfer pricing: practical manual for developing countries *continued*
5-6 p.m.	3 (e) Article 13: capital gains (E/C.18/2010/3) *Presenter*: Mr. Liao
Wednesday, 20 October 2010	
10-10.30 a.m.	Report of the Rapporteur on items 3 (c), (d) and (e)
10.30-11.15 a.m.	3 (f) Taxation of development projects (E/C.18/2010/CRP.5) *Presenters*: Mr. Sasseville and Mr. Thurony
11.15-12 noon	3 (g) Exchange of information (E/C.18/2010/CRP.6) (Including Code of Conduct update by Secretariat)
12 noon-1 p.m.	3 (h) Tax treatment of services (E/C.18/2010/CRP.7) *Presenter*: Ms. Kana
3-4 p.m.	3 (h) Tax treatment of services *continued*
4-6 p.m.	3 (i) Article 14 of the United Nations Model Convention (E/C.18/2010/4 and E/C.18/2010/CRP.8) *Presenter*: Ms Kana
Thursday, 21 October 2010	
10-10.30 a.m.	Report of the Rapporteur on items 3 (f), (g), (h) and (i)
10.30 a.m.-12 noon	3 (j) Definition of permanent establishment: proposed revised article 5 commentary (E/C.18/2010/5 and E/C.18/2010/6) *Presenter*: Mr. van der Merwe
12 noon-1 p.m.	3 (k) Concept of beneficial ownership (E/C.18/2010/CRP.9) *Presenter*: Mr. Louie
3-4.30 p.m.	3 (l) Revision of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (E/C.18/2010/CRP.10) *Presenter*: Mr. Arrindell
4.30-6 p.m.	3 (m) Capacity-building (E/C.18/2010/CRP.11) *Presenter*: Ms Omoigui-Okauru
Friday, 22 October 2010	
10-10.30 a.m.	Report of the Rapporteur on items 3 (j), (k), (l) and (m)
10.30-11.15 a.m.	3 (m) Capacity-building *continued*

Date	*Item*	
11.15-12.15 p.m.		3 (m) Tax cooperation and its relevance to major environmental issues, particularly climate change (E/C.18/2010/CRP.12) *Presenter*: Secretariat
12.15-1 p.m.		3 (o) Tax competition in corporate tax: use of tax incentives in attracting foreign direct investment. (E/C.18/2010/CRP.13) *Presenter*: Secretariat
3-4 p.m.	4.	Dates and agenda for the seventh session of the Committee
4-6 p.m.	5.	Adoption of the report of the Committee on its sixth session
6 p.m.		Closing of the sixth session

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Committee of Experts on International Cooperation in Tax Matters
Sixth session
Geneva, 18-22 October 2010
Item 3 (e) of the provisional agenda*
Article 13: capital gains

Paragraphs 4 and 5 of article 13 of the United Nations Model Tax Convention, and relevant commentary

Note by the Subcommittee on Capital Gains**

I. Introduction

1. At the fifth annual session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 19 to 23 October 2009, a Subcommittee on Capital Gains was convened.[1]

2. The Subcommittee was mandated as follows:

The Subcommittee will analyse and make proposals for consideration by the Committee on:

(a) Rewriting the commentary on the new paragraph 5 of article 13;

(b) Addressing the abuse issues relating to paragraph 5 and the policy issues allowing reasonable restructuring;

(c) Addressing the compliance issues of paragraph 4 and the possibility of rewriting this paragraph.

The Subcommittee will present a report on its progress at the next annual session of the Committee.

3. The present note represents the requested progress report on the Subcommittee's work.

* E/C.18/2010/1.

** The views and opinions expressed in the present note are those of the Subcommittee on Capital Gains (Coordinator: Mr. Liao) and should not be taken as necessarily representing those of the United Nations.

[1] E/2009/45, para. 10.

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II. New paragraph 5 of article 13

4. The new version of paragraph 5 of article 13, agreed by the Committee at its fourth annual session, in 2008[2] reads:

> Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least _____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

5. A commentary on the new paragraph was not prepared at that time, and the Subcommittee was requested to provide proposed text for consideration by the Committee. The Subcommittee's proposal follows.

III. Proposed commentary

6. The Subcommittee proposes the following commentary to replace current paragraphs 9 to 11 of the commentary on article 13. The current paragraphs 12 and 13 of the commentary, which relate to paragraph 6 of article 13, would consequently be renumbered as paragraphs 17 and 18. Proposed paragraphs 9 to 16 are as follows:

> "9. Some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State. However, it is recognized that for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12 month period preceding the alienation, held, directly or indirectly, a substantial participation. In this context, '12 month period' means the period beginning with the date which is one calendar year earlier than the date of the alienation and ending at the time of the alienation. The determination of what is a substantial participation is left to bilateral negotiations, in the course of which an agreed percentage can be determined.
>
> "10. This paragraph provides for taxation of a gain on the alienation of shares as contemplated in the paragraph above but excludes gains from the alienation of shares to which paragraph 4 of article 13 of the Model Convention applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 12 month period preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12 month period.
>
> "11. It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to

[2] E/C.18/2008/CRP.2, para. 8, and E/2008/45, para. 49.

determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in determining the level of the alienator's direct or indirect holdings. The treaty text itself or associated documents could alternatively expand on the meaning of these concepts.

"12. The question of laying down a concessionary rate of tax (compared with the normal domestic rate) on gains arising on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of companies principally owning immovable property, has also been considered. Since the gains arising on alienation of shares being taxed in a concessionary manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialization of the country, countries may consider discussing this matter during bilateral negotiations and making necessary provision in the bilateral tax treaties.

"13. It is costly to tax gains from the alienation of quoted shares. In addition, developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares. Countries that wish to do so may include in their bilateral tax treaties the following:

> 'Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, **excluding shares in which there is substantial and regular trading on a recognized stock exchange**, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least _____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.'

The treaty text itself or associated documents could expand on the meaning of the phrases 'substantial and regular trading' and 'recognized stock exchange'.

"14. Some countries might consider that the Contracting State in which a company is resident should be allowed to tax the alienation of its shares only if a substantial portion of the company's assets are situated in that State and in bilateral negotiations might seek to include such a limitation.

"15. Other countries engaged in bilateral negotiations might seek to have paragraph 5 omitted entirely, where they take the view that taxation in the source State of capital gains in these situations may create economic double taxation in the corporate chain, thus hampering foreign direct investment. This consideration is, in particular, relevant for countries that apply a participation exemption not only to dividends received from a substantial shareholding, but also to capital gains made on shares in relation to such substantial holdings.

"16. If countries choose not to tax the gains derived in the course of corporate reorganizations, they are of course also free to do so."

IV. Abuse issues relating to paragraph 5 and policy issues relating to reasonable restructuring

7. The Subcommittee considers that the abuse issues relating to paragraph 5 and the policy issues allowing reasonable restructuring are sufficiently dealt with in the proposed commentary on the new paragraph, as well as in the section entitled "Improper use of tax treaties" in changes to the commentary on article 1 previously agreed by the Committee of Experts.[3]

V. Compliance issues for paragraph 4 and the possibility of amending the paragraph[4]

8. Article 13, paragraph 4, currently reads as follows:

> "4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:
>
> > "(1) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.
> >
> > "(2) For the purposes of this paragraph, 'principally' in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate."

9. Some of the issues which the taxpayers and tax administrations have to address in applying the paragraph are listed below:

(a) How would the taxpayer who alienates his shares know that the property of the company, whose shares he has alienated, consists principally of "immovable property" situated in a particular State and discharge his tax obligations to that State? Balance sheets are finalized as of a particular date, and reflect the position of assets on that date while the alienation may be at a date which falls between the dates of the two balance sheets;

(b) It is also possible that the location of immovable properties may not be disclosed in the balance sheets available in the public domain. Where would the taxpayer access information to determine his tax obligation? The situation may be aggravated in cases where a person transacts in shares based on price movements of scrip in a stock exchange and makes no analysis of the financials;

(c) The phrase "immovable property" used in the paragraph has not been defined. Paragraph 1 of article 13 also uses this phrase but makes an explicit reference to article 6 and therefore the definition of "immovable property" in article 6

[3] E/C.18/2008/CRP.2, para. 12.

[4] This part was drafted for the Subcommittee by Ms. Anita Kapur, a member of the Subcommittee.

relates to paragraph 1 of article 13. However, in paragraph 4 there is no reference to article 6. This omission inspires the view that in the absence of a definition of "immovable property" in article 3, the phrase will have to take its meaning from the domestic law. A contrary view is that some international meaning to this term in preference to the domestic law meaning should contextually apply. Another view is that paragraph 4 ensures that the taxing rights in relation to immovable property in paragraph 1 are retained in the circumstances set out in paragraph 4 and "immovable property" should be interpreted as set out in paragraph 1. Clearly, this divergence in views of the resident State and source State can cause difficulties for the taxpayer;

(d) "Principally" in relation to ownership of "immovable property" has been defined to mean the value of such "immovable property" exceeding 50 per cent of the aggregate value of all assets. The issues requiring clarification are:

(i) The date for determining such value;

(ii) Whether the value is to be taken as book value, cost or fair market value;

(iii) Which are the assets to be reckoned? That is, whether all assets as per the books are included, or even the assets not in the books such as goodwill and other intangible property;

(iv) In a situation where the "immovable property" is situated in State A and the company is a resident of State B, and the share transaction takes place between residents of State B, the tax administration of State A may not have access to information regarding such transactions to assert the taxation right, because the company whose shares are alienated is not in its territory;

(v) Tax administrations may know or may not know of abusive attempts to evade the operation of paragraph 4 of article 13, particularly by shareholders with controlling interests, as the company can borrow short term to make the value of "immovable property" at the relevant time less than 50 per cent.

10. The Subcommittee considers it necessary to ascertain the practices and legal provisions applied by various tax jurisdictions in asserting their source taxation right under article 13, paragraph 4, before considering changes to that paragraph. It is also necessary to deliberate in the Committee on the issues posed in paragraph 9 of the present paper to decide on the guidance that the commentary should provide for making the provision as effective as possible.

VI. Interpretation of the term "indirectly" in paragraph 4

11. While the Subcommittee is of the view that the term "indirectly" in paragraph 4 of article 13, poses difficulties for, and may therefore result in differences of, interpretation, it believes that according to paragraph 2 of article 3 it is left to domestic laws rather than the treaty law to define the term. The practice in the domestic law of the country of one member[5] of the Subcommittee may be of some assistance, and that practice is therefore summarized as follows for reference:

Suppose Company A in State A holds 20 per cent of shares in Company B in State B. The asset value of Company B is 100 United States dollars, of which 40 United States dollars is the value of immovable property. Company B holds

[5] Mr. Tizhong Liao of China.

80 per cent shares in Company C. The asset value of Company C is 100 United States dollars, of which 90 United States dollars is the value of immovable property. Then for Company B:

The total asset value is 180 (100+100*80%);

The total value of immovable property is 112 (40+90*80%);

The value of immovable property versus movable property is 62 per cent.

Therefore when Company A sells its shares in Company B, State B should have the right to source taxation because more than 50 per cent of the value in Company B is from immovable property.

VII. Interpretation of the term "indirectly" in new paragraph 5

12. As with paragraph 4, the Subcommittee recognizes that the term "indirectly" in the new paragraph 5 of article 13 poses difficulties for, and may therefore result in differences of, interpretation. It considers, however, that according to paragraph 2 of article 3 it is left to domestic laws rather than the treaty law to define the term. The practice in the domestic law of one member[5] of the Subcommittee may be of some assistance, and is therefore summarized as follows for reference:

Suppose the percentage of shareholding established through bilateral negotiations is 25 per cent, the alienator shall be regarded as holding 25 per cent or more of the capital of the company, if:

(a) The alienator holds directly 25 per cent or more of the capital of the company which is a resident of the other Contracting State;

(b) The alienator holds indirectly, in a shareholding chain, 25 per cent or more of the capital of the company which is a resident of the other Contracting State. Indirect shareholding in a chain shall be computed by multiplying the shareholding percentages. For instance, if a company in State A holds 50 per cent of the shares in a company in State B, and the company in State B holds 50 per cent of a company in State C, then the company in State A indirectly holds 25 per cent (50 per cent of 50 per cent) of the shares in the company in State C. Under such circumstances, the gains derived by the company in State A from the alienation of the shares in the company in State B shall not be taxable in State C. However, if the company in State A directly holds shares of any percentage, for example 5 per cent, in the company in State C and sells the shares, the gains shall be taxable in State C;

(c) The combination of direct shareholding plus indirect shareholding reaches 25 per cent or more. For instance, if a company in State A holds 40 per cent of the shares in a company in State B, and the company in State B holds 40 per cent of the shares in a company in State C, then the company in State A indirectly holds 16 per cent (40 per cent of 40 per cent) of the shares in the company in State C. At the same time, the company in State A directly holds 10 per cent of the shares in the company in State C. Then the company in State A holds directly and indirectly 26 per cent (10 per cent plus 16 per cent) of the shares in the company in State C. Under such circumstances, the gains derived by the company in State A from the alienation of the shares in the company in State C shall be taxable in State C even if the company in State A only directly holds 10 per cent of the shares in the company in State C;

(d) The alienator's closely associated parties hold directly or indirectly 25 per cent or more of the capital of the company which is a resident of the other Contracting State. The closely associated parties usually include: (i) kinship members; (ii) dependent agencies, fiduciaries, trustees, nominees or other persons of the same or similar nature; (iii) an individual or a company that owns 100 per cent of the shares in a resident company; and (iv) a company that is wholly owned by the aforesaid individuals, companies, or other persons. Under such circumstances, the gains derived by the alienator who is a resident of a Contracting State from the alienation of his shares in the company which is a resident of the other Contracting State shall be taxable in that other State.

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Item 3 (i) of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters: article 14 of the United Nations Model Convention

Issues relating to article 14 of the United Nations Model Convention

Note by the Secretariat

1. The annexed note has been prepared by Professor Brian Arnold at the request of the Secretariat, acting on behalf of the Subcommittee on Article 14 of the United Nations Model Convention. The Subcommittee was mandated[1] by the Committee of Experts on International Cooperation in Tax Matters at its fifth annual session, in 2009, as follows:

> "The Subcommittee is mandated to propose updates and improvements to article 14, especially for those countries that would like to maintain this article. In particular, the problems with regard to scope, coverage and diverging interpretations should be addressed either by a new text for article 14, providing different options for solutions, or by drafting in the commentaries. The Subcommittee will present its conclusions at the next annual session."

2. The views expressed in the annexed note should not be taken as necessarily representing the views of the United Nations.

* E/C.18/2010/1.

[1] See E/2009/45-E/C.18/2009/6, paras. 9 and 10.

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Annex

Possible revisions to article 14 of the United Nations Model Convention

I. Introduction

1. The present note has been prepared[a] for the Subcommittee on Article 14 of the United Nations Model Convention, as mandated by the Committee of Experts on International Cooperation in Tax Matters at its Fifth Session, in the report on the session (E/2009/45-E/C.18/2009/6), held in Geneva from 19 to 23 October 2009. The mandate of the Subcommittee is as follows:

> "The Subcommittee is mandated to propose updates and improvements to article 14 especially for those countries that would like to maintain this article. In particular, the problems with regard to scope, coverage and diverging interpretations should be addressed either by a new text for article 14, providing different options for solutions, or by drafting in the commentaries. The Subcommittee will present its conclusions at the next annual session."

2. At its fifth session, the Committee of Experts approved changing the wording of article 5 (3) to refer to 183 days, rather than to six months. The Committee also approved the addition to the commentary on article 5 of the following alternative version of article 5 (3) for those countries wishing to delete article 14:

> "The term 'permanent establishment' also encompasses:
>
> "(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
>
> "(b) The furnishing of services by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or connected project) within a contracting State for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the fiscal year concerned;
>
> "(c) For an individual, the performing of services in a contracting State by that individual, but only if the individual's stay in that State is for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the fiscal year concerned."

3. The Committee also agreed that the commentary on article 5 would reflect the fact that some countries did not agree with the view (as reflected in the new wording) that article 14 applies exclusively to individuals.

4. The present note discusses and makes recommendations for changes to the wording of article 14 and to the commentary for those countries that wish to retain article 14. In general, those countries take the view that article 14 applies to both individuals and entities. The present note does not address the broader issues concerning the appropriate treatment of income from services generally or the

[a] By Professor Brian Arnold.

treatment of fees for technical services under the United Nations Model. Those issues will be considered in a separate note ("the other note") that will be provided to the Subcommittee.[b] Nor does the present note repeat the comprehensive and thorough analysis of the interpretive issues arising under article 14 referred to in the paper of the Subcommittee on the Definition of Permanent Establishment entitled "Proposal for amendments to the United Nations Model Double Taxation Convention between Developed and Developing Countries: further issues relating to permanent establishment"[c] (hereinafter referred to as the Subcommittee paper).

5. The present note begins with a brief section setting out the assumptions or guiding principles on which the analysis contained in the note is based, followed by a brief description of the provisions of articles 7, 14 and 21 applicable to services. The scope of article 14 and the relationship between articles 7 and 14 are examined in detail to allow an assessment as to whether the changes to article 14 proposed in the present note would result in any significant change to the scope of source-country taxing rights. Several of the major interpretive issues arising under the existing wording of article 14 are then analysed. This part of the note is not intended to be exhaustive; only the major issues are addressed, and then only briefly. The note ends with recommendations for revising article 14 of the United Nations Model, primarily by moving article 5 (3) (b) into article 14. A draft of the revised article 14 is provided for discussion purposes. Possible revisions to the commentary on article 14 are also noted; at this stage, however, it would be premature to provide draft commentary.

II. Assumptions or guiding principles

6. In my view, it is important to articulate clearly the assumptions or guiding principles on which the analysis contained in the present note is based. If those assumptions or principles are invalid, the analysis may be suspect and thus may need to be revised. The assumptions or guiding principles are as follows:

(a) There should be no significant change in the scope of source-country taxation. Consequently, any revisions to article 14 should not reduce source-country taxing rights with respect to income from services. The possible expansion of the scope of source-country taxation of income from services will be considered in the other note (on taxation of services) referred to above;

(b) The major interpretive difficulties under the existing article 14 should be eliminated or clarified;

(c) There should be consistent treatment of income from various types of services under the provisions of the United Nations Model unless there are convincing reasons for different treatment. Thus, dependent and independent services, and professional, technical, commercial and any other services, performed by individuals or entities should in principle be subject to the same tax treatment. In this context, "the same tax treatment" means that the same threshold for source-country taxation, the same rules for determining the amount of income subject to

[b] The note will be annexed to E/C.18/2010/CRP.8.

[c] E/C.18/2008/CRP.3, available at http://www.un.org/esa/ffd/tax/fourthsession/.

source-country taxation, and so forth, should be applied to all types of services.[d] However, it is assumed that the special treatment provided for certain types of services dealt with in specific provisions of the United Nations Model (such as entertainment and Government services) is justified;

(d) It is appropriate to offer countries some limited degree of choice with respect to the treatment of income from services.

III. Overview of the provisions of the United Nations Model dealing with services

7. Several provisions of the model conventions of both the Organization for Economic Cooperation and Development (OECD) and the United Nations deal with various types of services. For the purposes of the present note, as mentioned above, the provisions of article 5 (6) (Insurance), article 8 (Shipping, inland waterways transport and air transport), article 16 (Directors' fees and remuneration of top-level managerial officials), article 17 (Artistes and sportspersons) and article 19 (Government service) of the United Nations Model are disregarded, because they deal with specialized types of services. For the same reason income from dependent personal services (employment) is not discussed.

Article 7

8. Under article 7, income from services rendered by an enterprise resident in one contracting State in the other contracting State may be taxed in the other contracting State (the source country) only if the enterprise carries on business in the source country through a permanent establishment in the source country. If the enterprise carries on business through a permanent establishment in the source country, only the profits that are attributable to the permanent establishment or to other activities carried on in the source country that are the same as or similar to those carried on through the permanent establishment (a "limited force of attraction" rule) are taxable by the source-country. It is generally accepted that the source country tax under article 7 is limited to the net profits of the non-resident enterprise.

9. A permanent establishment is defined in article 5 to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. Also, a dependent agent is deemed to be a permanent establishment of a non-resident enterprise if the agent has and habitually exercises an authority to conclude contracts on behalf of the non-resident enterprise. The term "permanent establishment" also encompasses a building site, a construction, assembly or installation project or supervisory activities in connection with such a site or project if the site, project or activities last more than 183 days (currently six months). Construction and related services performed by a non-resident in the source country will be taxable by the source country only under these conditions. More generally, the term "permanent establishment" also encompasses the furnishing of services by a non-resident if the activities continue for more than 183 days (currently six months) and if they take place with respect to the same or a connected project.

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[d] It must be recognized that consistency in the treatment of income from services under the United Nations Model is difficult to achieve, given that some countries wish to delete article 14, while other countries wish to retain it.

10. It is unclear whether article 5 (3) (a) is a deeming provision or whether it simply prescribes an additional condition (a six-month time requirement) for a construction site to constitute a permanent establishment. Under the OECD Model, it is reasonably clear that article 5 (3), dealing with construction sites, is an additional condition, not a deeming provision. In other words, in order to constitute a permanent establishment, a construction site must meet the requirements of article 5 (1) and must also last for at least 12 months. With respect to the United Nations Model, this interpretation is not as clear. Article 5 (3) (b) is clearly a deeming provision, because otherwise it would be meaningless (it would apply only to services provided through a fixed place for a continuous period of more than 183 days). It represents an alternative to article 5 (1), not an additional requirement. If this is correct, then it is arguable that article 5 (3) (a) is also a deeming provision, unlike article 5 (3) of the OECD Model.[e] This issue should be clarified in the commentary.[f]

Article 14

11. Under article 14, income from professional services or other independent activities derived by a resident of one State in another State is subject to taxation by the other State in the following two circumstances:

(a) The resident has a fixed base in the other State that is regularly available to the resident for the purpose of performing the activities. In this case, which is similar to those dealt with by article 7, only the income attributable to the fixed base is taxable by the source country;

(b) The resident's stay in the source country lasts for 183 days or longer in the aggregate in any 12-month period. In this case, only the income from activities performed in the source country are taxable by the source country.

Article 21

12. Article 21 gives a source country the authority to tax items of income not dealt with in other articles of the treaty if such items of income have their source or arise in the source country. Consequently, if income from services is not subject to taxation by a source country under article 7 or article 14 for any reason, the income is arguably subject to tax under article 21. This result must be contrasted with the result under article 21 of the OECD Model, which gives the right to tax other income exclusively to the residence country.

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[e] Arguably, it is questionable whether article 5 (3) (a) is a deeming provision. For example, under article 5 (1), a fixed place of business must have geographical and commercial coherence. Thus, a business project that is carried on at different places is carried on through a permanent establishment only if the business is carried on at each place for at least six months. If article 5 (3) (a) is a deeming provision, then a construction project that is carried on in different places for more than six months would be deemed to be a permanent establishment, although it does not meet the requirements of article 5 (1).

[f] If article 5 (3) (b) were moved to article 14, as recommended in the present note, the problem would be largely resolved if not eliminated. There would be no argument that the requirements of article 5 (1) must be met in order for income from services to be taxed under article 14. The issue of whether article 5 (3) (a) is a deeming provision would remain; however, unaccompanied by article 5 (3) (b), it would be similar to article 5 (3) of the OECD Model.

13. The meaning of the phrase "not dealt with" is uncertain. One interpretation is that an item of income is not dealt with in an article unless it is subject to tax under that article. The other interpretation is that an item of income is dealt with in an article if it is income of the same nature as that of the income dealt with in the article. Under this interpretation, any items of business income not taxable under article 7 would nevertheless be considered to be dealt with in article 7, so that article 21, which would otherwise allow the source country to tax such income, would not apply.

14. In my view, it is inappropriate for article 21 to apply to income from services. Under articles 7 and 14, income from services is taxable only if a non-resident has a substantial presence in the source country. Article 21 should not allow source-country taxation simply if the income is sourced or arises in the country. Although article 21 is beyond the scope of the present note, it may be worthwhile to add a brief statement to the commentary on article 21 to clarify this issue.

The scope of article 14

15. The scope of application of article 14 can be seen from the brief description of the provision given above. It is important to precisely delimit that scope in order to ensure that any changes made to the wording of article 14 do not significantly reduce or expand source-country taxing rights. It is also important to identify any overlap or inconsistency between the provisions of articles 7 and those of article 14 with respect to income from services.[8] Not surprisingly, the major issues involved in determining the scope of application of article 14 are also some of the major interpretive issues that are discussed in more detail below.

16. In basic structural terms, the scope of article 14 can be determined by reference to the following factors:

(a) *The persons covered*. By its terms, article 14 applies to income from certain services derived by "a resident of a contracting State". Under article 4, "a resident of a contracting State" is defined as "any person" who is liable to tax under the laws of the State by reason of certain criteria. Under article 3 (1) (a), "a person" is broadly defined to include "an individual, a company and any body of persons". On the basis of those provisions, it seems clear that article 14 applies to income from services derived by both entities and individuals. However, this issue is not clear, for four reasons. First, the heading of article 14 is "Independent personal services". The word "personal" suggests that the article is restricted to services rendered by natural persons. In this regard, article 14 is a companion to article 15, which applies to dependent personal services. The words "he" and "his" in article 14, point to the same conclusion. Secondly, under the laws of some countries, professional and independent services can be performed only by individuals. Thirdly, paragraph 9 of the commentary on article 14 indicates that payments to an enterprise in respect of services provided by its employees or other personnel are

[8] Overlap between the provisions of article 7 and those of article 14 will create no difficulties as long as the tax consequences under both articles are the same. If the tax consequences under the two articles differ, it would be necessary to determine which article would apply in any particular situation. Although it is possible to attempt to make the tax consequences under articles 7 and 14 identical, it is impossible to ensure that, in the future, taxpayers, tax administrations and courts will not take the position that they differ. For this reason, it is preferable, in my view, to eliminate the possibility of overlap between the two articles.

subject to article 7. Fourthly, it is unclear how article 14 (1) (b) applies to entities. *The revised wording of article 14 as proposed below in the present note clarifies that article 14 applies to services rendered by entities*;

(b) *The types of income or services covered*. Article 14 applies to "professional services and other activities of an independent character". Professional services are defined inclusively and broadly in article 14 (2), indicating that article 14 is not limited to professional activities in a narrow traditional sense. Again, article 14 should probably be seen as a companion to article 15. The latter applies to employment or dependent personal services; the former applies to services performed by independent contractors. On the other hand, the commentary (para. 10) indicates that article 14 does not apply to industrial and commercial activities. There is no convincing (reason based on either the literal wording of article 14 or policy considerations) to restrict article 14 to professional services, although some countries apparently do so. *The revised wording of article 14 as proposed below in the present note clarifies that article 14 applies generally to all types of services*;

(c) *The conditions that must be satisfied in order for the source country to be entitled to tax income from services*. A source country is entitled to tax income from services under article 14 only if the taxpayer has a fixed base in the source country that is regularly available to him or her for the purpose of performing the services or if the taxpayer stays in the source country for 183 days or more. The commentary suggests that the meaning of the term "fixed base" in article 14 is the same as that of the term "fixed place of business" in the definition of "permanent establishment" in article 5 (1), despite the fact that the two terms are clearly different. Moreover, under article 14, a fixed base must be regularly available to the taxpayer, whereas under article 5 (1) a taxpayer's business must be carried on through the fixed place of business. It is unclear whether those two requirements are the same.

IV. A comparison of the scope of articles 7 and 14

17. The analysis set out below compares the scope of article 14, as described above, with the scope of article 7 in respect of income from services. This comparison is made on the basis of the same three factors referred to above to determine the scope of article 14:

(a) *The persons covered*. Article 7 applies to the profits of "an enterprise of a contracting State", which is defined in article 3 (1) (c) as an enterprise carried on by "a resident of a contracting State", which in turn is defined in article 4 as "any person" who is liable to tax under the laws of the country on the basis of certain factors. A person is defined broadly in article 3 (1) (a) to include both individuals and legal entities. Consequently, in terms of persons covered, the scope of article 7 is at least as broad as that of article 14, on the assumption that article 14 applies to entities, and broader than that of article 14, on the assumption that article 14 is restricted to individuals. Therefore, article 14 should be revised to clarify that it applies to both individuals and entities. Issues also arise concerning the treatment of partnerships under article 14. These issues are discussed paragraphs 18 and 19 of the Subcommittee paper;

(b) *The types of income or services covered*. Article 7 applies to profits from the carrying on of a business. Neither the term "business" nor the term "profits" is

defined in the treaty. As a result, by virtue of article 3 (2), those terms have the meaning that they have under the law of the State applying the treaty unless the context requires otherwise. Accordingly, if professional or other services are considered not to constitute the carrying on of a business under the domestic law of a State (which appears to be the case in some countries), article 7 would not apply unless the tax authorities or the courts conclude that the context of the treaty requires that the term "business" for the purposes of the treaty should have a broader meaning than under domestic law. In contrast, article 14 applies only to a specific type of business income, namely, income from professional and other independent services. For those countries that consider professional and other independent services to be a business under domestic law, there will be considerable overlap between articles 7 and 14. However, in any case where both provisions apply, article 7 (6) gives priority to article 14;

(c) *The conditions that must be satisfied in order for the source country to be able to tax income from services.* Under article 7, the source country is entitled to tax income from services if the non-resident taxpayer carries on business through a permanent establishment in the source country. A permanent establishment is defined in article 5. In order to compare the scope of application of articles 7 and 14 with respect to services, it is necessary to make a detailed comparison of: (i) the concepts of a fixed place of business and a fixed base; and (ii) the provisions of article 5 (3) (b) and article 14 (1) (b). Article 5 deals with insurance, construction, assembly, installation and related supervisory services. Article 14 does not cover these services unless they are considered to be professional services or services of an independent nature. In any cases in which such services are dealt with by both article 7 and article 14, article 14 takes precedence as a result of article 7 (6). In any comparison of the concept of a fixed base and a permanent establishment, the most important point is that the former is not defined at all, whereas the latter is defined extensively in article 5. Thus, there is inevitably more uncertainty concerning the meaning of a fixed base then there is concerning the meaning of a permanent establishment;

(i) *Comparison of "fixed base" and "fixed place of business".* The commentary on article 14, which is borrowed from the former commentary on article 14 of the OECD Model, states that articles 7 and 14 are based on the same principles (para. 10 of the commentary on article 14). This statement has led some commentators to suggest that the term "fixed base" has the same meaning as that of a permanent establishment in article 5. Some courts have reached the same conclusion.[b] Furthermore, the OECD commentary (para. 11 of the commentary on article 5) indicates that no differences in meaning between "fixed base" and "permanent establishment" were intended. Although there may be some subtle differences between the concept of a fixed base and that of a permanent establishment, it seems unlikely that those differences have any serious practical significance. The Subcommittee came to the same conclusion (see Subcommittee paper, paras. 29-38 and annex 5).[c] The concept of a fixed base could reasonably be interpreted to be the equivalent of a fixed place of business as referred to in article 5 (1). On the basis of this equivalence, it might be possible to read the exemptions for preparatory and

[b] *Dudney v. The Queen* [2002], 2 CTC 56 (FCA); Supreme Court of the Netherlands, 25 March 1992, BNB 1992/245; and Supreme Court of the Netherlands, 24 June 1981, BNB 1981/236.

[c] The Committee as a whole did not agree on this point.

auxiliary activities in article 5 (4) into article 14. It seems more difficult to incorporate the agency permanent establishment rules in article 5 (5) and (7) into article 14; however, those rules have less significance for most service businesses than for other types of businesses. Article 5 (1) defines a fixed place of business as a permanent establishment if the business of the enterprise is wholly or partly carried on through the fixed place. In contrast, article 14 requires that the fixed base be regularly available to the taxpayer. It is unclear whether there is any significant difference between those requirements.[j] The commentary on article 5 (1) indicates that a fixed place of business is a permanent establishment only if it is "at the disposal" of the taxpayer. This condition is similar, if not identical, to the condition that a fixed place be "regularly available" to the taxpayer. Even if there are differences between the concept of a fixed base and that of a fixed place of business, there is no justification for the term "fixed base" to be interpreted more broadly or more narrowly than the fixed-place-of-business aspect of the definition of a permanent establishment. Unless the distinction between "fixed base" and the fixed-place-of-business aspect of the definition of a permanent establishment is eliminated, the risk of inappropriate results will remain;[k]

(ii) *Comparison of articles 5 (3) (b) and 14 (1) (b)*. Article 14 (1) (b) applies if the non-resident service provider stays in the source country for 183 days or more in the aggregate in any 12-month period commencing or ending in the relevant fiscal period. The commentary on article 14 (para. 6) makes it clear that this provision is based on the taxpayer's physical presence in the source country, which presumably should be applied on the same basis as the similar test in article 15 (2). Paragraph 1 of the commentary on article 15 clarifies that all days of presence are counted for this purpose irrespective of whether the taxpayer is working. In contrast, article 5 (3) (b) is a much narrower provision. It applies only if the service activities (working days) continue for more than 183 days (currently 6 months) in any 12-month period; moreover, the services must be provided for the same or a connected project. Therefore, some situations covered by article 14 (1) (b) are not covered by article 7. For this reason, the alternative version of article 5 will include a provision similar to article 14 (1) (b). However, the same or connected project requirement will be retained in article 5 (3) (b). In addition, there is a difference between the thresholds for source-country taxation under the alternative version of article 5 and article 14. Although there is a significant difference between the threshold under article 5 (3) (b) (days of service for the same or a connected project) and that under article 14 (1) (b) (days of presence) of the current United Nations Model, that difference would be reduced or eliminated under the amended wording of article 5. The addition of article 5 (3) (c) effectively moves existing article 14 (1) (b) into article 5. The only difference between article 14 (1) (b) and the new article 5 (3) (c) is that the new article 5 (3) (c) applies only to

[j] Any uncertainty in this regard would be eliminated if article 14 is deleted.

[k] For example, there is no time requirement for a fixed base specified in article 14 or the commentary, whereas a minimum period of six months is specified for permanent establishments in paragraph 6 of the commentary on article 5 of the OECD Model. Therefore, it is possible for the phrase "regularly available" to be interpreted to mean a period of more or less than the six-month period generally applicable in respect of fixed-place-of-business permanent establishments.

individuals, whereas, according to some countries, article 14 (1) (b) applies to both individuals and entities. It is unclear whether this is a serious practical problem. For countries that apply article 14 only to individuals or professional services, the deletion of article 14 is unlikely to result in any significant reduction in source-country taxing rights. The jurisdiction of such countries to tax may actually expand, because professional services rendered by entities and independent services rendered by individuals would be taxable under article 7 on the basis of the new article 5 (3) (c). On the other hand, the taxing rights of any countries that apply article 14 to entities and to independent services, may be reduced if article 14 is deleted. Under article 14 (1) (b), the source country is entitled to tax if the non-resident is present in the source country for 183 days or more. However, if article 14 is deleted, the source country would be entitled to tax entities only if the non-resident entity's employees or other personnel work in the source country for more than 183 days (currently six months) on the same or a connected project. Because of the wording of article 14 (1) (b), its application to entities is unclear. Apparently, there are more than 20 countries that take the position that article 14 applies to entities. The wording of article 14 should be revised to clarify that it applies to entities. There is a broader question concerning the appropriateness of source countries' taxing income from services derived by non-residents under the conditions specified in article 14 (1) (b), those specified in article 5 (3) (b) or other conditions. This question is considered in the note on services.

V. The major interpretive issues under article 14

Does article 14 apply to entities?

18. It is unclear whether article 14, as currently worded, applies only to individuals or to both individuals and entities. Professional and other independent services can be performed by both individuals and entities under the laws of some countries. There is no justification for applying different rules under the United Nations Model treaty to individuals and entities performing the same services. Article 14 should be amended to clarify that it applies to entities. Such an amendment would increase the overlap between articles 7 and 14; however, by virtue of article 7 (6), article 14 would take precedence in any such case. Such an amendment would also raise the question of the application of the physical-presence threshold under article 14 (1) (b) to entities and the relationship between article 5 (3) (b) and article 14 (1) (b). This issue is discussed below.

Services covered

19. By its terms, article 14 applies only to professional and other services of an independent nature. Income from other services is dealt with under article 7. As a result, it is necessary to determine the nature of the services performed by a taxpayer in order to apply article 14. For example, it is unclear whether article 14 applies to fees derived for technical assistance. As noted in the section of the present note setting out assumptions and general principles, there is no relevant distinction between professional and other services in the modern economy. Income from services is simply a particular type of business income. In general, income from services should be subject to the same rules under the United Nations Model as other types of business income unless there are good reasons for different treatment.

This argument supports subjecting all services to the same rules to the extent possible while retaining article 14. Thus, article 14 should be revised to make it applicable to all services other than those that are performed through a fixed place of business and, as a result, are subject to article 7. This alternative would involve deleting article 5 (3) (b) and adding a similar provision to article 14. There would still be borderline issues between articles 7 and 14. However, dealing with all services other than those performed through a permanent establishment would represent a sensible allocation for the taxation of services between articles 7 and 14 and would clarify the source-country taxation of income from such services, as distinguished from the taxation of business income generally.

Fixed base

20. The use of a fixed-place threshold for the source-country taxation of professional services under article 14 causes unnecessary uncertainty. As discussed above, there is considerable debate as to whether a fixed base is the same as or different from a fixed place of business. Irrespective of whether the concepts are the same or different, the use of two terms requires that other provisions of the Model refer to both terms. In the absence of reference to both terms, uncertainty is created as to whether the particular provision applies to both, or only to the term mentioned. For example, the protection against discrimination in article 24 (3) applies literally only to permanent establishments; it should apply equally to non-residents providing services through a fixed base. However, the absence of any reference to a fixed base in article 24 (3), when contrasted with several other provisions that refer to both permanent establishments and fixed bases, may lead to an interpretation of article 24 (3) that restricts it to permanent establishments.

21. Article 14 would be clarified if it were revised to apply only to income from services performed by a non-resident in circumstances where the non-resident does not have a fixed place of business in the source country. This is the key issue to be considered in deciding on the scope of article 14. In the modern economy, a resident of one country can render services in another country without having any fixed place of business there. The critical question is under what conditions source countries should be entitled to tax such income from services. Given the current provisions of article 5 and article 14 (and on the alternative services permanent establishment provision that was recently added to the commentary on article 5 of the OECD Model), it seems that there is widespread agreement that a source country is entitled to tax income from services where the non-resident service provider is present in the source country or is performing services in the source country for a significant period (more than 183 days) during a year.

Time thresholds

22. The time thresholds in articles 5 (3) (b) and 14 (1) (b) are inconsistent for no apparent reason. Article 5 refers to a six-month period, while article 14 refers to a period of 183 days. This difference will be eliminated, because the new version of article 5 (3) (b) refers to 183 days. There is a further inconsistency, in that article 5 (3) (b) refers to a period or periods aggregating more than 183 days, whereas article 14 (1) (b) refers to a period or periods amounting to or exceeding in the aggregate 183 days. These time limits should be consistent.

Computational rules

23. Article 14 does not provide any rules for the computation of the income attributable to a fixed base or derived from activities performed in the source country. The commentary on article 14 (para. 10) indicates that the computational rules in article 7 should apply for the purposes of article 14. However, this is not completely clear. Some countries may take the position that income from services under article 14 may be taxed by way of withholding on a gross basis without allowing any deductions. If article 14 is deleted and the alternative version of article 5 is adopted, the computation of income from services previously dealt with under article 14 would be subject to the rules of article 7. In my view, this would be the appropriate result. Therefore, if article 14 is retained, it should be amended to clarify that any income from services taxable by a source country should be determined in accordance with the same basic rules as those applicable under article 7. Thus, if a source country wishes to use withholding as a collection device for non-resident service providers, it must allow them to file a return on a net basis and to claim a refund for any excessive withholding tax.[1]

24. The application to article 14 of the new rules for the computation of the profits attributable to a permanent establishment under the proposed article 7 and commentary of the OECD Model is beyond the scope of the present note.

VI. Recommendations

25. On the basis of the foregoing analysis, there are two options for improving article 14. The first is to leave the basic scope of article 14 unchanged and to try to clarify the interpretive issues. At the very least, this would involve defining the term "fixed base" and clarifying the application of article 14 to entities. In my opinion, this option would be unlikely to produce satisfactory results; it is not discussed further in the present note. The second option is to revise article 14 of the United Nations Model to deal with income from services generally, other than income from services earned through a fixed place of business, construction and insurance services. In particular, article 5 (3) (b) should be deleted from article 5 and incorporated into article 14 with certain modifications.

26. Currently, certain income from services is dealt with under article 7 and certain other income from services is dealt with under article 14. Unlike other articles, such as articles 17 and 19, which deal with special types of services, the provisions of both article 7 and article 14 can be viewed as general provisions, especially if article 14 is considered to apply to all independent services, not only professional services, and to services provided by entities as well as by individuals. The current United Nations Model is confusing in this regard because there is considerable overlap between the two articles and they differ significantly.

27. It would be preferable if the United Nations Model had one article that dealt with services generally and other articles that dealt only with special types of services. The deletion of article 14 would achieve that result. Some countries, however, consider that the alternative version of article 5 (3) and the deletion of article 14 are not successful in fully incorporating article 14 into article 5. For that

[1] If article 24 (3) applies to article 14, a source country might be precluded from imposing a withholding tax on non-resident service providers.

reason, they wish to retain article 14. For those countries, the goal should be to achieve the same result — one article that deals with services generally and other articles that deal with special types of services — through amendments to article 14.

28. Under this approach, article 7 would deal with special or limited types of income from services, namely, construction, insurance[m] and services performed through a fixed place of business. Article 14 would be revised to deal with income from services more generally. More specifically, article 5 (3) (b) would be moved from article 5 to article 14; the fixed-base concept would be eliminated, and the scope of article 14 would be revised to cover all income from services and all taxpayers. This approach is attractive, because it would create parallel treatment for those countries that delete article 14 and those countries that retain article 14.

29. Under the approach set out above:

(a) **Article 5 (3) (b) should be deleted. The commentary on article 5 would contain the alternative wording of article 5 (3) approved by the Committee of Experts for those countries wishing to delete article 14;**

(b) **Article 14 would be revised as follows:**

Article 14

Income from Services

1. **Subject to the provisions of articles 15, 16, 18 and 19, income derived by an enterprise of a contracting State in respect of services shall be taxable only in that State except in the following circumstances, when the income may also be taxed in the other contracting State:**

(a) **The enterprise furnishes services [including consultancy services], through one or more individuals engaged by the enterprise for such purpose, but only if activities of that nature continue within the other contracting State for a period or periods aggregating 183 days or more[n] within any 12-month period commencing or ending in the fiscal period concerned; or**

(b) **If the enterprise is an individual who furnishes services in the other contracting State, but only if the individual's stay in that State is for a period or periods aggregating 183 days or more[o] in any 12-month period commencing or ending in the fiscal year concerned.**

2. **If an enterprise of a contracting State furnishes services in the other contracting State in the circumstances described in paragraph 1 (a) or (b), only the income derived from the services performed in the other State may be taxed in the other State.**

30. Several other consequential amendments to other articles would be necessary. The references to the term "fixed base" in other articles should be deleted.

31. In any situation in which both article 7 and article 14 apply (for example, construction services), article 14 would prevail pursuant to article 7 (6). This seems

[m] Consideration should be given to moving article 5 (6) to article 14.

[n] Alternatively, the time limit could be worded as "more than 183 days".

[o] Alternatively, the time limit could be worded as "more than 183 days".

to be an appropriate result, especially in the light of the fact that the alternative services permanent establishment rule in the commentary on article 5 of the OECD Model prevails over article 5 (1), (2) and (3). It should be noted that under the proposed version of article 14 the overlap between articles 7 and 14 would be limited. The extent of the overlap could be reduced further if article 5 (6), dealing with insurance services, were deleted from article 5 and added to article 14.

32. The proposed article 14 contains no exception for preparatory or auxiliary services because, in my view, such an exception is unnecessary and undesirable.[p] The Subcommittee on the Definition of Permanent Establishment concluded that the exception for preparatory or auxiliary activities would be relevant for services only in rare cases and suggested that some countries might wish to exclude the application of the exception to services (see Subcommittee paper, paras. 40-49).

33. The same or connected project requirement in article 5 (3) (b) has not been included in the revised version of article 14 set out above. As discussed more fully in the note on services, that requirement is an inappropriate restriction on the taxing rights of source countries with respect to income from services. The note on services recommends that the requirement that services be performed in connection with the same or a connected project be deleted from article 5 (3) (b). If that recommendation is accepted, the conditions for the taxation of income from services under article 7 and article 14 would be consistent in that regard.

Additional amendments to article 14

Rules for the determination of income from services subject to tax

34. The commentary on article 14 (para. 10) provides that, because the principles upon which articles 7 and 14 are based are the same, the rules for the allocation of profits between a head office and a permanent establishment can be applied to services performed from a fixed base. That commentary provides further that expenses incurred for the purposes of the fixed base should be deductible in computing the income attributable to the fixed base in accordance with article 7 (3).

35. For countries that delete article 14 and adopt the alternative version of article 5 (3), the result obviously is that the rules in article 7 apply and require income from services taxable under article 7 to be taxed on a net basis. Moreover, the provisions of article 24 (3) would apply, precluding a source country from taxing income from services derived by non-residents in a discriminatory fashion in comparison with residents. The Subcommittee concluded that this would be the appropriate result (see Subcommittee papers, para. 57).

36. If, on the other hand, article 14 is retained and revised as recommended in the present note, the concept of a fixed base would be eliminated. Therefore, the issue is whether rules are necessary, in article 14 itself or in the commentary, concerning the determination of the income subject to source-country tax and, in particular, the deduction of expenses in computing such income. In the absence of such rules, it would continue to be uncertain whether income under article 14 was taxable on a net or a gross basis. Other provisions of the United Nations Model that refer to "income", such as those of articles 6 and 17, allow for source-country taxation on a

[p] The OECD alternative services provision regarding permanent establishment contains the exception for preparatory and auxiliary activities.

gross basis. On the other hand, those articles can be seen as exceptional. Taxpayers who perform independent services often incur significant expenses in doing so. Moreover, expenses would be deductible under article 7 if the services were performed through a permanent establishment. Therefore, source countries should be required to tax income from services under the revised article 14 on a net basis. This result can be achieved by adding a provision to article 14 itself, by amending the commentary on article 14 to clarify that expenses must be deductible, or by revising article 24 (3) to make it applicable to a resident of a contracting State deriving income from services performed in the other contracting State that are taxable under article 14.

37. If Article 24 (3) is revised to apply to non-resident service providers subject to source-country tax under article 14, source countries would be precluded from imposing final gross-based withholding taxes on non-resident service providers unless resident service providers were subject to similar taxes. However, article 24 (3) prevents a source country from taxing non-residents less favourably than residents; it does not prevent non-residents from being taxed differently from residents to take account of their different circumstances. Therefore, source countries would be able to require interim withholding on fees paid to non-resident service providers as long as those non-residents were entitled to file tax returns on a net basis and to claim a refund for any excessive withholding.

38. If some source countries wish to tax non-resident service providers on a gross basis (perhaps because they lack the administrative resources to process and verify returns on a net basis), the United Nations Model could authorize them to do so. It can be argued that income from services derived by non-residents is no different from income derived from immovable property situated in a country or income derived by non-resident entertainers and athletes. On the other hand, it can be argued that income from services generally is more like income from business, which is taxable on a net basis under article 7. One possible solution would be to allow source countries to tax income from services on a gross basis but to limit the rate of tax as is done for dividends, interest and royalties under articles 10, 11 and 12. In other words, under article 14 of the United Nations Model, source countries would have the choice of taxing income from services derived by non-residents on a net basis with no limitation on the rate of source-country tax, or on a gross basis with a limitation on the rate of source-country tax (say, for example, 20 per cent).

Non-discrimination protection for non-resident service providers

39. As discussed above, if article 14 is retained, article 24 should be amended to provide protection against discrimination for non-resident service providers on terms similar to the protection afforded by article 24 (3) for non-residents carrying on business through a permanent establishment.

The OECD alternative permanent establishment rule for services

40. In 2008, the commentary on article 5 of the OECD Model was revised to add an alternative provision deeming a permanent establishment to exist in certain circumstances where an enterprise of one contracting country performs services in the other contracting country. The OECD alternative provision clearly draws on article 5 (3) (b) and article 14 (1) (b) of the United Nations Model. However, the OECD alternative provision also makes a number of improvements on the

provisions of the United Nations Model. Those improvements do not result in any significant reduction in source-country taxing rights. As a result, some of those improvements should be incorporated into article 14 of the United Nations Model or into the alternative wording of article 5 (3), for those countries that delete article 14. The improvements that should be incorporated into the United Nations Model are described briefly below:

(a) The OECD alternative provision deals more effectively than the provisions of the United Nations Model with situations in which individuals provide services on behalf of entities that they own. For example, under article 14 of the United Nations Model (including the draft revised article 14 in the present note), income from services provided by an individual who stays in the source country for more than 183 days is subject to source-country tax. However, such an individual may be able to avoid source-country tax by performing the services as an employee of a corporation all of whose shares are owned by the employee, or as a partner in a partnership;

(b) The OECD alternative provision clarifies that if an enterprise uses independent contractors to perform services on its behalf, those individuals will not be taken into account unless the enterprise directs, supervises or controls the activities of those individuals;

(c) The commentary relating to the OECD alternative provision contains several useful explanations that should be added to the commentary on article 14 or on article 5 (3), if article 14 is deleted. For example, the OECD commentary clarifies the relationship between the construction site permanent establishment rule and the alternative services permanent establishment rule, explicitly states that the provision applies only to services rendered to other persons (not services performed for the enterprise itself), and provides helpful examples to illustrate the application of the provision.

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Discussion of substantive issues related to international cooperation in tax matters: definition of permanent establishment: proposed revised article 5 commentary

Proposed new Commentary on Article 5: paragraphs 1 to 15.13

Note by the Working Group on Definition of Permanent Establishment**

I. Introduction

1. At the fifth session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 19 to 23 October 2009, a number of working groups were convened in cases where an issue had already been dealt with and approved by the Committee, but where further work was required.

2. The Working Group on Definition of Permanent Establishment is mandated to:[1]

> finalize the current work on the definition of permanent establishment, involving work related to finalizing the Commentary on Article 5 including revising the Commentary for greater coherence with Article 14 (for those who wish to retain that Article). It was recognized that, in the longer term, revisions to the Commentary on Article 5 might be required to maximize coherence and consistency with Article 14, including any changes made to that Article and its Commentaries.

* E/C.18/2010/1.

** The views and opinions expressed in the present note are those of the working group on definition of permanent establishment (Coordinator: Peter van der Merwe) and do not necessarily represent those of the United Nations.

[1] See *Official Records of the Economic and Social Council, 2009, Supplement No. 25* (E/2009/45), paras. 9 and 10.

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II. Proposed commentary

3. In order to ensure that its work could be made as widely available as possible for the United Nations Committee of Experts on International Cooperation in Tax Matters at its sixth session, the Working Group has addressed proposed paragraphs 1 to 15.13 of the Commentary on Article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries[2] in the present note (see annex). Paragraphs 15.14 to 37 are considered in the companion note (E/C.18/2010/6), and the two papers should be considered together.

4. The proposed Commentary reflects the new Commentary agreed by the Committee at its 2007 annual session,[3] with proposed changes to deal with the amendments to the text of Article 5 agreed at the 2009 annual session and reflected in the report of that session.[4] In accordance with the Working Group's mandate, however, the proposed Commentary also addresses the option of removal of Article 14, should negotiating countries agree to do so in a bilateral treaty. This reflects the decision taken by the Committee at its fifth annual session in 2009.[5]

5. Any substantive proposed changes to the content of the annex to conference room paper E/C.18/2008/CRP.10 are presented in bold for emphasis, as this note does not seek to reopen the text previously agreed by the Committee, except as required by its mandate.

[2] United Nations publication, Sales No. E.01.XVI.2.

[3] See E/C.18/2008/CRP.10.

[4] See *Official Records of the Economic and Social Council, 2009, Supplement No. 25* (E/2009/45), paras. 17-19.

[5] Ibid., para. 18.

Annex

Proposed amended Commentary on Article 5 of the United Nations Model (Paras. 1 to 15.13)

ARTICLE 5

PERMANENT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

1. Article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (hereinafter referred to as the "UN Model") is based on Article 5 of the OECD Model Tax Convention (hereinafter referred to as the "OECD Model") but contains several significant differences. In essence these are that under the UN Model:

- there is a six-month test for a building or construction site constituting a permanent establishment, rather than the 12-month test under the OECD Model, and it expressly extends to assembly projects, as well as supervisory activities in connection with building sites and construction, assembly or installation projects (para. 3 of the UN Model Article);

- the furnishing of services by an enterprise through employees or other personnel results in a permanent establishment where such activities continue for a total of ~~**6 months in a twelve month period**~~ **more than 183 days in any 12-month period commencing or ending in the fiscal year concerned** (para. 3(b));

- **Article 14 (Independent Personal Services) has been retained, whereas in the OECD Model, Article 14 has been deleted, and Article 5 addresses cases that were previously considered under the "fixed base" test of that Article. As noted below (in para. 15.1 and thereafter), while the UN Model has retained Article 14, the present Commentary provides guidance for those countries not wishing to have such an article in their bilateral tax agreements;**

- in the paragraph 4 list of what is deemed *not* to constitute a permanent establishment (often referred to as the list of "preparatory and auxiliary activities") "delivery" is not mentioned in the UN Model, but is mentioned in the OECD Model. Therefore a delivery activity might result in a permanent establishment under the UN Model, without doing so under the OECD Model;

- the actions of a "dependent agent" may constitute a permanent establishment, even without having and habitually exercising the authority to conclude contracts in the name of the enterprise, where that person habitually maintains a stock of goods or merchandise and regularly makes deliveries from the stock (para. 5 (b));

- there is a special provision specifying when a permanent establishment is created in the case of an insurance business; consequently a permanent establishment is more likely to exist under the UN Model approach (para. 6); and

while an independent agent acting as such will usually not create a permanent establishment for the enterprise making use of the agent because such an agent is effectively operating his own business providing a service. **As with the OECD Model**, the UN Model indicates that such an agent devoting all or nearly all their time to a particular client and not dealing with the client at an arm's length basis is not treated as having the necessary independence (para. 7).

These differences are considered in more detail below.

2. The concept of "permanent establishment" is used in bilateral tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. Specifically, the profits of an enterprise of one State are taxable in the other State only if the enterprise maintains a permanent establishment in the latter State and only to the extent that the profits are attributable to the permanent establishment. The concept of permanent establishment is found in the early model conventions including the 1928 model conventions of the League of Nations. The UN Model reaffirms the concept.

E. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 5

Paragraph 1

3. This paragraph, which reproduces Article 5 (1) of the OECD Model, defines the term "permanent establishment", emphasizing its essential nature as a "fixed place of business" with a specific "situs". According to paragraph 2 of the OECD Commentary (the 2008 version of which is cited below), this definition contains the following conditions:

- the existence of a "place of business", i.e., a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be "fixed", i.e., it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The OECD Commentary goes on to observe:

> *3.* It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has "a productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4 The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g., for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance, where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g., a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

4.6 The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 20 below).

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

The OECD Commentary then examines some examples relating to the provision of services. In quoting the following two paragraphs, the Committee notes that Article 5 (3) (b) of the UN Model provides a specific provision in relation to furnishing of services by an enterprise through employees or personnel engaged for that purpose. In practice, therefore, the points made in paragraphs 5.3 and 5.4 of the OECD Model Commentary (as with other parts of the OECD Commentary to Article 5 (1)) may have less significance for the UN Model than in their original context.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result

in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However, if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

The OECD Commentary then continues:

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

The Committee agreed with the approach taken in paragraph 6 of the OECD Commentary, while recognizing that such situations will not often arise in practice,

and that special care should therefore be taken when relying on paragraph 6 as applicable in an actual case. The OECD Commentary continues:

> *6.1* As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.
>
> *6.2* Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12-month period provided for in paragraph 3 would equally apply to such cases.
>
> *6.3* Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated.
>
> *7.* For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.
>
> *8.* Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility

and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of [six] months applies. Other cases have to be determined according to the circumstances.

10. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g., dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business. But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

11. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

4. Paragraph 2, which reproduces Article 5 (2) of the OECD Model, lists examples of places that will often constitute a permanent establishment. However, the provision is not self-standing. While paragraph 2 notes that offices, factories, etc., are common types of permanent establishments, when one is looking at the operations of a particular enterprise, the requirements of paragraph 1 must also be

met. Paragraph 2 therefore simply provides an indication that a permanent establishment may well exist; it does not prove that one necessarily does exist. This is also the stance of the OECD Commentary, where it is assumed that States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1". Developing countries often wish to broaden the scope of the term "permanent establishment" and some believe that a warehouse should be included among the specific examples. However, the deletion of "delivery" from the excluded activities described in paragraph 4 (a) and (b) means that a "warehouse" used for any purpose is (subject to the conditions in paragraph 1 being fulfilled) a permanent establishment under the general principles of the Article. The OECD Commentary points out in paragraph 13 that the term "place of management" is mentioned separately because it is not necessarily an "office" and that "where the laws of the two Contracting States do not contain the concept of a 'place of management' as distinct from an 'office', there will be no need to refer to the former term in their bilateral convention".

5. In discussing subparagraph (f), which provides that the term "permanent establishment" includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD Commentary states that "the term 'any other place of extraction of natural resources' should be interpreted broadly" to include, for example, all places of extraction of hydrocarbons whether on or offshore. Because subparagraph (f) does not mention exploration for natural resources, whether on or offshore, paragraph 1 governs whether exploration activities are carried on through a permanent establishment. The OECD Commentary states:

> *15.* Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:
>
> (a) shall be deemed not to have a permanent establishment in that other State; or
>
> (b) shall be deemed to carry on such activities through a permanent establishment in that other State; or
>
> (c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.
>
> The Contracting States may moreover agree to submit the income from such activities to any other rule.

6. As mentioned above, in subparagraph (f) the expression "any other place of extraction of natural resources" should be interpreted broadly. Some have argued that, for this purpose, a fishing vessel could be treated as a place of extraction or exploitation of natural resources since "fish" constitute a natural resource. In their analysis, although it is true that all places or apparatus designated as "permanent establishments" in subparagraphs (a) to (e) in paragraph 2 have a certain degree of permanence or constitute "immovable property", fishing vessels can be considered

as a place used for extraction of natural resources, which may not necessarily mean only minerals embedded in the Earth. In this view, fishing vessels can be compared to the movable drilling platform that is used in off-shore drilling operations for gaining access to oil or gas. Where such fishing vessels are used in the territorial waters or the exclusive economic zone of the coastal State, their activities would constitute a permanent establishment, situated in that State. However, others are of the view that such an interpretation was open to objection in that it constituted too broad a reading of the term "permanent establishment" and of the natural language of the subparagraph. Accordingly, in their opinion, any treaty partner countries which sought to advance such a proposition in respect of fishing activities, should make that explicit by adopting it as a new and separate category in the list contained in this Article. Consequently, the interpretation on the nature of this activity has been left to negotiations between Contracting States so that, for example, countries which believe that a fishing vessel can be a permanent establishment might choose to make that explicit in this Article, such as by the approach outlined in paragraph 13 of this Commentary. The interpretation as to the nature of this activity would, therefore, be left to negotiations between Contracting States.

Paragraph 3

7. This paragraph covers a broader range of activities than Article 5 (3) of the OECD Model, which states, "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months". In addition to the term "installation project" used in the OECD Model, subparagraph 3 (a) of the UN Model includes an "assembly project" as well as "supervisory activities" in connection with "a building site, a construction, assembly or installation project". Another difference is that while the OECD Model uses a time limit of 12 months, the UN Model reduces the minimum duration to six months. In special cases, this six-month period could be reduced in bilateral negotiations to not less than three months. The Committee notes that there are differing views about whether paragraph 3 (a) is a "self-standing" provision (so that no resort to paragraph 1 is required) or whether (in contrast) only building sites and the like that meet the criteria of paragraph 1 would constitute permanent establishments, subject to there being a specific six-month test. However, the Committee considers that where a building site exists for six months, it will in practice almost invariably also meet the requirements of paragraph 1. In fact, an enterprise having a building site, etc., at its disposal, through which its activities are wholly or partly carried on will also meet the criteria of paragraph 1.

8. Some countries support a more elaborate version of paragraph 3 (a), which would extend the provision to encompass a situation "where such project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activities exceed 10 per cent of the sale price of the machinery or equipment". Other countries believe that such a provision would not be appropriate, particularly if the machinery were installed by an enterprise other than the one doing the construction work.

9. Article 5 (3) (b) deals with the furnishing of services, including consultancy services, the performance of which does not, of itself, create a permanent establishment in the OECD Model. Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can

generate large profits. **In the (2011) version of the UN Model, the Committee agreed to a slight change in the wording of subparagraph 3 (b), which was amended to read: "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned", rather than, "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any 12-month period", as it formerly read. This was seen as providing greater consistency with the approach taken in Article 14 (1) (b).**

10. A few developing countries oppose the six-month **(or 183 days)** thresholds in paragraph 3 (a) and (b) altogether. They have two main reasons: first, they maintain that construction, assembly and similar activities could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise; second, and more fundamentally, they simply believe that the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as it is in the case of artistes and sportspersons under Article 17). Other developing countries oppose a time limit because it could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory. However, the purpose of bilateral treaties is to promote international trade, investment, and development, and the reason for the time limit (indeed for the permanent establishment threshold more generally) is to encourage businesses to undertake preparatory or ancillary operations in another State that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that State.

11. In this connection, the OECD Commentary observes, with changes in parentheses to take account of the different time periods in the two Models:

> *18.* The [six]-month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g., for a row of houses). The [six]-month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

The Committee points out that measures to counteract abuses would apply equally in cases under Article 5 (3) (b). The Commentary of the OECD Model continues as follows:

> *19.* A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g., if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st [August] because of bad weather conditions or a lack of materials but resumed work on 1st [October], completing the road on 1st [January] the following year, his construction project should be regarded as a permanent establishment because [eight] months elapsed between the date he commenced work (1st May) and the date he finally finished (1st [January] of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project, subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. The subcontractor himself has a permanent establishment at the site if his activities there last more than [six] months.

The Committee considers that the reference in the penultimate sentence of this paragraph of the OECD Commentary to "parts" of such a project should not be taken to imply that an enterprise subcontracting *all* parts of the project could never have a permanent establishment in the host State.

The Commentary of the OECD Model continues as follows:

> *19.1* In the case of fiscally transparent partnerships, the [six]-month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds [six] months, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.
>
> *20.* The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such a case, the fact that the work force is not present for [six] months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts for more than [six] months.

12. Subparagraph (b) encompasses service activities only if they "continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than **183 days in any 12-month period commencing or ending**

in the fiscal year concerned ~~**six months within any 12-month period**~~". The words "for the same or a connected project" are included because it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of ~~**three months'**~~ **95 days'** duration and another enterprise with two unrelated projects, each of ~~**three months'**~~ **95 days'** duration, one following the other. However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of ~~**four or five months'**~~ **120 or 150 days'** duration.

13. If States wish to treat fishing vessels in their territorial waters as constituting a permanent establishment (see para. 6 above), they could add a suitable provision to paragraph 3, which, for example, might apply only to catches over a specified level, or by reference to some other criterion.

14. If a permanent establishment is deemed to exist under paragraph 3, only profits attributable to the activities carried on through that permanent establishment are taxable in the source country.

15. The following passages of the Commentary on the OECD Model are relevant to Article 5 (3) (a) of the UN Model, although the reference to an "assembly project" in the UN Model and not in the OECD Model, and the six-month period in the UN Model should, in particular, be borne in mind:

> *16.* This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed and risks assumed through that office or workshop are attributed to the permanent establishment. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.
>
> *17.* The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipelines and excavating and dredging. Additionally, the term "installation project" is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a

building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

Alternative text for countries wishing to delete Article 14

15.1. **Some countries have taken the view that Article 14 should be deleted and its coverage introduced into Articles 5 and 7. Countries taking such a view often do so because they perceive that the "fixed base" concept in Article 14 has widely acknowledged uncertainties and that the "permanent establishment" concept can accommodate the taxing rights covered by Article 14. This approach is expressed by the Commentary on Article 5 of the OECD Model as follows:**

> *1.1* **Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.e., Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.**

15.2 **Many countries do not hold to these views, do not believe they are sufficient to warrant deletion of Article 14, or consider that differences in meaning exist between the "fixed base" (Article 14) and "permanent establishment" (Article 5) concepts, and that because of these differences, the removal of Article 14 and reliance on Articles 5 and 7 will, or at least may, in practice lead to a reduction of source State taxing rights. Considering the differences of views in this area, differences which could not be bridged by a single provision, the Committee decided that Article 14 would be retained in the UN Model but that guidance in the form of an alternative provision would be provided in this Commentary for countries wishing to delete Article 14 and address situations currently covered by it under Articles 5 and 7.**

15.3 **This alternative differs from that provided for under the OECD Model, which reflected in its changes the conclusions of a report on Article 14 released in a 2000 OECD report.[6] That report suggested certain changes to Articles of the OECD Model (and bilateral treaties) as well as consequential changes to the Commentaries. Since most countries deleting Article 14 will be doing so for the reasons outlined in the OECD report, and are likely to follow the recommendations in the OECD Model, the changes to the Articles proposed in that report, as they now appear in the OECD Model, are addressed in the paragraphs below regarding the possible deletion of Article 14. The differences**

[6] Organization for Economic Cooperation and Development, *Issues in International Taxation Issues Related to Article 14 of the OECD Model Tax Convention: No. 7* (Organization for Economic Cooperation and Development, 2000).

between that approach and the alternative wording provided below, result from relevant differences between Article 14 of the UN Model and Article 14 as it previously appeared in the OECD Model.

15.4 Since the deletion of Article 14 is merely presented as an option that some countries may prefer to follow, the entire discussion on the consequential implications of such an approach is addressed in this Commentary on Article 5, including identifying the possibility, and in most cases the need, to make certain consequential changes reflecting the deletion of Article 14, the need to remove references to "independent personal services" and "fixed base" and the possibility of removing references to "dependent personal services" for the sake of clarity.

Changes to Articles 14 and 5

15.5 Article 14 would be deleted. Subparagraph (b) of Article 5 (3) would read as follows:

> "(b) the furnishing of services by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or connected project) within a Contracting State for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned;"

15.6 The changes to the version of this subparagraph in the 2001 UN Model are minor, comprising (i) the deletion of the words "including consultancy services", after the words "the furnishing of services", on the basis that the wording was unnecessary and confusing, such services being clearly covered; (ii) the replacement of the six-month test with the 183 days test, as noted in paragraph 9 above; and (iii) the use of a semicolon rather than a period at the end of the subparagraph, with the introduction of subparagraph (c).

15.7 A new subparagraph 3 (c) would also be inserted, as follows:

> "(c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual's stay in that State is for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the fiscal year concerned."

15.8 Subparagraph (c) is intended to ensure that any situation previously covered by Article 14 would now be addressed by Articles 5 and 7. The wording reflects the fact that deletion of Article 14 of the UN Model would involve deletion of the "days of physical presence" test found in subparagraph 1 (b) of Article 14 of that Model, which had no counterpart in the OECD Model when the deletion of Article 14 was agreed for that Model.

15.9 It should be noted that subparagraph (c), in attempting to reflect operation of the current Article 14 (1) (b), more explicitly indicates that the subparagraph only applies to individuals. In this respect, it follows and makes clearer the interpretation found in paragraph 9 of the Commentary on Article 14, to the effect that Article 14 deals only with individuals. The Committee notes that some countries do not accept that view and should seek to clarify the issue when negotiating Article 14.

15.10 It should also be noted that the last part of Article 14 (1) (b) has not been transposed into Article 5: ("... in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State"). The reason for this is that Article 7 provides its own attribution rules, which, in most cases, means that only the profits of an enterprise attributable to that permanent establishment (that is, the "physical presence" in subparagraph 3 (c)) may be taxed by the State where the permanent establishment exists. In the relatively small number of cases where a "limited force of attraction" rule as provided for in Article 7 has been adopted in bilateral treaties, other business activities of a same or similar kind as those effected through the physical presence permanent establishment may be taxed by the State where the permanent establishment exists, which can be justified as treating various forms of permanent establishment in the same way. In the event, likely to be very rare in practice, of States agreeing to a limited force of attraction rule in Article 7 and also to deletion of Article 14, but not wishing to apply the limited force of attraction rule to cases formerly dealt with by Article 14 (1) (b), it could explicitly be provided that such a rule did not apply to subparagraph (3) (c) cases.

Consequential changes to other Articles

5.11 In paragraph 1 of Article 3, existing subparagraphs (c) to (f) should be renumbered as subparagraphs (d) to (g) and the following new subparagraphs (c) and (h) added:

> *"(c) the* term *"enterprise" applies to the carrying on of any business;*
>
> *"(h) the* term *"business" includes the performance of professional services and of other activities of an independent character."*

15.12 The reasoning for this change is reflected in paragraphs 4 and 10.2 of the OECD Commentary on Article 3 as follows:

> *4.* The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term "enterprise" has therefore been attempted in this Article. However, it is provided that the term "enterprise" applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary are free to omit the definition of the term "enterprise" from their bilateral conventions.
>
> *10.2* The Convention does not contain an exhaustive definition of the term "business", which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies to the Convention. [S]ubparagraph (*h*), however, provides expressly that the term includes the performance of professional services and of other

activities of an independent character. This provision was added in 2000 at the same time that Article 14, which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term "business" includes the performance of the activities that were previously covered by Article 14, was intended to prevent that the term "business" be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting States for which this is not the case are free to agree bilaterally to omit the definition.

15.13 Paragraph 4 of Article 6 should be amended by removing the reference to independent personal services as follows:

"*4.* The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise ~~and to income from immovable property used for the performance of independent personal services~~."